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TAX ADVANTAGE RETIREMENT SAVINGS FOR THE MILITARY

by

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Preface

My overall goal for this research project is for you, the reader, to become informed on the changes that have occurred in the military retirement and the affects on readiness. Surprisingly, during my research, I discovered many REDUX military members do not know they are under the 40% retirement instituted in the Military Reform Act of 1986. If those individuals read my report, understand the retirement system better and intelligently convey their concerns to our senior leaders, then maybe there will be more impetus for change.

I thank Major Skip Thomas, my faculty advisor, for all his assistance on my project. His knowledge guided me in the right direction. His contacts in the personnel offices around the Air Force provided valuable sources and first hand knowledge of the topic. He gave me the freedom to tackle this problem my way, yet provided the insight to prevent me from straying too far off course.

Abstract

The erosion of the military retirement system is a contributing cause to readiness problems in the Air Force. It is time to change the retirement system to one, which provides more to the military member than the current plan implemented under the Military Retirement Act of 1986 (commonly referred to as REDUX.) The introduction previews the problem, its background and its significance. In chapter 2, the history of the military retirement system is analyzed to provide the reader with the necessary background of why the retirement system is structured in its current format and what legislative action led to the current plan. In the next chapter, the affects of the retirement plan on military readiness is analyzed, specifically, its impact on retention, recruitment and morale. Chapter 4 covers the possible changes to the retirement plan now under review by various agencies. In chapter 5, the author outlines his proposal to improve the retirement system. The basic REDUX plan remains, however he proposes an immediate basic pay raise and a vehicle for tax advantaged savings. Next, he suggests a new investment strategy for the military retirement account. This change will help defray the cost of the immediate increase in basic compensation. Finally, chapter 6 concludes the project with a summary of the paper and urges the changes proposed in chapter 5.

Chapter 1

Introduction

We need Congressional support to stabilize and preserve the military retirement system. Our readiness depends on it.

—The Honorable F. Whitten Peters
Acting Secretary of the Air Force
Statement to House National Security Committee, 26 Mar 98

The military retirement system has been the target of congressional cutbacks long before the post Desert Storm draw down and decreases in military spending. Some argue the military retirement system is excessive and should be scaled back even further in this era of fiscal responsibility. Others believe the erosion of the retirement system and the erosion of military benefits in general is creating a readiness problem. Which side of the aisle is correct?

Statement of the Research Question

Should the military change the retirement system and allow tax advantaged retirement savings? Currently, members of the armed forces are not eligible for a tax advantaged retirement savings program, other than their own private Individual Retirement Account (IRA), which is capped at an annual $2,000 contribution. Military members are eligible for a lifetime annuity after 20 years of service. Historically, less than 18 % of active duty military members serve 20 years and beyond.[1] Therefore, over

82 % of our veterans of the armed forces who serve 5, 10 and in some cases 15 years or more get nothing in terms of retirement savings for their military service. Implementing a vehicle for tax advantaged retirement savings is the *right* thing to do!

Background and Significance of the Problem

Readiness and quality of life are important concerns for the military. These two topics are listed in the Air Force Issues Papers for 1998. The readiness of our Armed Forces faces significant challenges in the form of retention, recruitment and morale. There is a perception among active duty members that their military benefits are eroding in the form of lack of quality health care, inadequate housing and a military pay gap, to name a few. It is beyond the scope of this research paper to investigate the validity of these perceptions, however the erosion of the military retirement system and the remedy for it are the target of this research paper. It is a fact, the military retirement system has been cut twice since 1980, and since 1993 has been the target of 17 legislative proposals to further reduce the value of military retirement compensation.[2] The military retirement system affects retention, recruitment and morale and therefore impacts our readiness. It's time to thwart any more attacks on the retirement system, reverse the trend and reward the members of our Armed Forces with a tax advantaged savings program.

Preview of the Argument

The Military Retirement Reform Act of 1986 (REDUX) has negatively affected retention, recruitment and morale. These three aspects of military readiness are the lowest seen in the past decade. These issues are complicated and are tied to many factors, not just to retirement. However, an improvement in retirement benefits will help retention, recruitment and morale. The retirement system is only a subset of the larger military compensation package. The compensation package could be altered to improve it for all members at minimal cost to the taxpayers.

Notes

[1] Pyatt, Colonel Richard, et al. *Military Retirement – A Time to Change?* Strategy Research Project (Carlisle Barracks, PA: U.S. Army War College, 1998), v.

[2] Anderson, Colonel Paul B., Chief, Investigations and Legislative Division, Department of the Army, General Staff. subject H.R. 3933, 105th Congress, 22 September, 1998.

Chapter 2

History of the Military Retirement System

> *Preserving Military Retirement Systems and Benefits – In the face of ongoing budgetary reviews, the stability of our current systems and the preservation of retired pay is crucial to future retention efforts.*
>
> 1998 Air Force Congressional Issue Papers

According to the Military Compensation Background Papers, there are four purposes for the military retirement system. First, a provision for a socially acceptable payment to members of the armed forces during their old age. Next, a system that is competitive not only with Federal Civil Service, but also with the private sector. Third, the military retirees provide a pool of experienced manpower that can be called upon in time of crisis or war to augment the active duty force. Finally, retirement eligibility after 20 years of service provides the mechanism to keep our armed forces young and vigorous, thereby allowing promotion opportunities for the junior ranks.[1] The military retirement system, as it exists today, has a legislative history dating back to 1861. Before that time, there was no legislative authority to provide for the voluntary or involuntary retirement of members of the armed forces. This caused readiness problems for the military. Officers remained on active duty until death. Senior commanders were not physically able to perform their duties and would often take leave in order to avoid going to the field with their men. A legislative act in 1861 authorized voluntary retirement after 40 years of services.[2] The Naval Service Appropriations Act of 1917 established the basis for the 20-year retirement and the formula for calculating retirement pay that remained unchanged through 1980. This calculation is 2.5 % of final monthly basic pay for each year of service up to 30, for maximum retirement pay of 75 % of final monthly basic pay. This is the retirement calculation used for those who entered service prior to September 8th 1980. This act also provided for the involuntary retirement of members that did not make promotion after a specified term of service.[3] There are also some unique characteristics of the military retirement program that set it apart from any other civilian or federal service program. All military retirees are subject to recall to active duty. Additionally, they are subject to the Uniformed Code of Military Justice (UCMJ).[4] With the Department of Defense Authorization Act of 1981, Congress began its modern day attack on the military retirement system. Because of rising costs, Congress changed the formula for calculating retirement pay. Retirees who entered service between September 8th 1980 and July 31st 1986, receive the same percentage but their monthly pay is calculated as the average of their final 3 years of service. In addition, this act eliminated the rounding rule. For example, a retiree with 20 years and 7 months service would receive retirement pay based on 20 years of service instead of 21 years of service.[5] This plan is commonly called "High 3". Congress was now keenly aware of the rising costs of the military retirement system and took steps in 1984 to prepare for these costs. The Department of Defense Act of 1984 established a Military Retirement Fund whereby an additional percentage of the annual appropriation of basic pay was invested in the Military Retirement Fund. Essentially, Congress put aside and invested retirement money active duty members earned each year.[6]

REDUX

In search of more cuts in defense spending, Congress once again trimmed the military retirement. In the Defense Authorization Act of 1986, Congress mandated a $2.9 billion reduction in military retirement fund accrual for fiscal year 1986.[7] The resulting change in the military retirement system is formally known as the Military Retirement Reform Act of 1986 (MRRA) and informally called REDUX. Military members who entered service after 31 July 1986 are covered under REDUX. The basic formula for calculating retirement pay remains unchanged for those who serve 30 years or beyond, however the multiplier is reduced 1% point for each year of service less than 30. For example, a retiree under REDUX with 20 years of service receives 40% of his monthly pay instead of 50%. In addition, the inflation multiplier under REDUX was reduced to Consumer Price Index (CPI) minus one, instead of the full CPI authorized under the other retirement plans. One criticism of the current retirement system is that it allows members to retire at a significantly younger age than the civilian sector. The 20-year retirement term was not an arbitrary number. It is a time period that allows an ample pool of experienced leadership to remain in the service for 20 years and still provide the incentive for the member to leave the service to allow the younger members upward mobility. Proponents of the REDUX plan tout the incentive for members to stay until 30 years when this may not actually be the desired force management tool. REDUX eligible members actually have a disincentive to stay until 20. They realize a 30-year military career is reserved for a select few members, because of the limited promotion opportunities after 20 years of service. The three retirement plans are outlined in Table 1 and 2.

Table 1. Summary of Retirement Systems

PLAN	ELIGIBLIBILTY	PAY FORMULA	COST OF LIVING ADJUSTMENT (COLA)
Final Basic Pay	Entered Service prior to 8 Sept 1980	2.5% times the years of service times basic pay	Full inflation protection COLA based on CPI
High-3	Entered service between 8 Sept 1980 and 31 July 1986	2.5% times the years of service times the average to the highest 3 years of base pay	Full inflation protection COLA based on CPI
MRRA or REDUX	Entered service after 31 July 1986	2.5% times the years of service minus 1 percentage point for each year less than 30 years times the highest 3 years of base pay. At age 62, High-3 formula is used.	Partial inflation protection COLA based on CPI minus 1 percentage point. At age 62, retired pay is adjusted to reflect full COLA since retirement. Partial COLA continues after age 62.

Source: Talking Paper on Retirement Systems, Major Mike Stark HQ USAF/DPRC

Table 2. . Annual Retired Pay for an O-5 with 20 years

Age	Final Pay (3.5% COLA adjusted)	High 3 (3.5% COLA adjusted)	REDUX (2.5% COLA adjusted)
42	$29,734	$27,226	$21,780
52	$41,943	$38,404	$27,881
62	$59,165	$54,173	$54,173
72	$83,458	$76,417	$69,346
81	$113,744	$104,148	$86,604
Total Percent	$2,514,035 100%	$2,301,932 91.6%	$1,940,211 77%

Source: Retired Officers Association

After examining the figures in table 1 and table 2, the disparity of the 3 retirement programs becomes much clearer. Note the gradual decline of the REDUX plan caused by the COLA adjustment figures. At age 62, the REDUX and High 3 retirees receive the same annual annuity because of the one time adjustment, but the High 3 continues to outpace the REDUX after age 62 because of the COLA adjustment figures. The numbers for enlisted are similar. The salary disparity for an E-7 under REDUX compared to a E-7 under the Final Pay plan is 22 %. One final note, of our current active duty force, nearly two-thirds are under the REDUX plan. A significant number of these members are past the 10-year mark. and are seriously considering retirement.[8] What is the impact on retention and morale? Will the REDUX plan dissuade young Americans from serving their country? These issues will be examined in the next chapter.

Notes

[1] Senate, *Proposal to Change the Military Retirement: before the Subcommittee on Manpower and Personal of the Committee on Armed Services,* 99th Cong., 1st sess., 1985,52.

[2] Robert R. Morris, *Military Compensation Background Paper* (Washington, D.C.: Department of Defense, 1996), 512.

[3] Ibid. 513.

[4] Ibid. 506.

[5] Ibid. 520.

[6] Ibid.

[7] Senate, *Proposal to Change the Military Retirement: before the Subcommittee on Manpower and Personal of the Committee on Armed Services,* 99th Cong., 1st sess., 1985,52.

[8] Rick Maze, "Should Redux be Retired," *Air Force Times,* 21 September, 1998, 4.

Chapter 3

Affects on Military Readiness

> *I believe there is no element [retirement] of the military compensation system more vital to the enduring readiness of our armed forces.*
>
> —Lt. Gen. John A. Shaud, USAF, Deputy Chief of Staff for Personnel
> 1985 statement to U.S. Senate Subcommittee on Manpower and Personnel

Military readiness is affected by, among other things, retention, recruitment and morale. The 1986 Military Retirement Reform Act has negatively impacted all three. During the debate of this legislation in the Senate hearings of the Armed Services Committee in December 1985, Martin M. Ferber, from the General Accounting Office, stated the following.

> It is DOD's assessment that the retirement changes would have severe consequences and result in a loss of about 41,000 service members who would have otherwise remained in the military...Retention analyses and survey data show that the prospect of retiring after 20 years of service becomes very important only after 8 to 10 years. It is not just the amount of retirement pay that encourages retention, but the all-or-nothing aspect of the 20 year retirement system, and to a lesser extent the other retirement benefits that continue.

In contrast to Ferber, Lt. Gen. Shaud defended the military retirement system. He feared its affect on readiness in stating the following during the same debate in the Senate Armed Services Committee.

> No other element of the military compensation system is more important to our career personnel. Our studies and surveys consistently reaffirm that the military retirement system is the number one career incentive; and

> cutting this system is the one thing that would most readily cause the loss of our talented and experienced careerists. Our people view this entitlement as the stable and unifying element in an otherwise volatile compensation system, and as deferred compensation for the many sacrifices we call on them to make. I am concerned that this cost savings agenda could undermine the morale of our men and women in uniform. They might perceive that Congress no longer values their sacrifices as much, while the sacrifices we ask them to make have not changed.

Both of these gentlemen had predications of the affect of REDUX. It is now 13 years after their statements, and the total force has stabilized after the post Desert Storm draw down. Who was correct? Historically, retention decreases when overall compensation decreases, and retirement is part of the overall military compensation package. Decreasing compensation coupled with a thriving economy logically leads to a retention problem.

Pilot retention is the most serious problem of the USAF.[1] Granted, the pilot retention issue is not focused on the retirement system. (The top reason listed on exit surveys is too many deployments.) However, the lure of a more lucrative job with the airline industry is also near the top of the exit surveys.[2] This proves compensation, although not the top reason for the pilot exodus is affecting retention. For calendar year 1998, pilot retention for 6-11 year aviators stood at 46%.[3] The pilot shortage is so extreme that even if the Air Force retained 100% of its pilots, there would still be a shortage. The Air Force's short-term answer is a bigger bonus for aviators. Maybe this bonus, coupled with a change in the retirement system, could lure more pilots to stay for a 20-year career.

Other officer career fields posted concerning retention statistics for 1998. The Office of Retention Policy, HQ USAF, divides officer retention into 4 categories: pilot, navigator, non-rated operations and mission support. In the rated career fields, they monitor the 6-11 year groups and 4-11 year groups in the non-rated career fields. The pilot statistics were previously highlighted. Navigator retention was 62% while non-rated operations stood at 56%, and mission support was 41%. While the retention office did not state any specific Air Force goals for the non-rated careers, the numbers have them "cautiously concerned."[4]

An equally concerning issue is the retention of experienced enlisted personnel. In 1997 the USAF's top enlisted man, CMSAF Eric W. Benken, warned Air Force leadership that enlisted retention "is going south"[5] The major concern is with second-term reenlistment. These airmen are the backbone of the enlisted force. They are the experienced members of the career fields; the ones most likely to conduct on the job training for the new airmen. The government has already invested thousands of dollars in training them in their specialty, and they can not be replaced overnight. The Air Force is losing them at an alarming rate. Second term reenlistment has been steadily declining for three years.[6] For 1998 and through 28 February 1999,the Air Force failed to meet any of the enlisted retention goals (see table 3).

Table 3. Enlisted Retention

	1998	**1999 (as of 28 Feb)**	**Goal**
1st Term	**54%**	**45%**	***55%***
2nd Term	**69%**	**70%**	***75%***
Career	**93%**	**90%**	***95%***

Source: Office of Retention Policy, HQ USAF/DPFFR

Retention in some critical career fields is much worse. Air traffic controllers are at 52% retention rate, space systems operators, 51% and com-computer system controllers are at 31%.[7] All of these second and third term airmen are under the REDUX plan and are at the point in their military career, when the retirement plan plays a bigger role in their decision making process. Certainly the retention problems are not solely the fault of REDUX, however the retirement system is a contributor. Airmen are aware military retirement benefits have eroded, and they are opting for the lure of jobs in the civilian market. A former commander of the Mission Support Squadron (MSS) at RAF Lakenheath conducted an exit survey of all base personnel that separated from the Air Force during her tenure. According to her survey, REDUX was one of the top 3 reasons listed by personnel leaving the Air Force.[8] Army statistics reflect a correlation also. Ten percent of mid term enlisted who left the Army in 1997 cited retirement benefits as the number one reason for leaving the service. In 1992, only 1% listed retirement benefits as their top reason.[9] These quality mid term enlisted personnel will have to be replaced by new recruits. What affect is the erosion of the retirement system having on recruitment?

Recruitment of quality personnel is becoming more difficult. Department of Defense surveys indicate that only 26% of men and 12% of women are interested in military service. This figure has steadily declined since 1991.[10] The smaller the pool from which to choose logically leads to a decline in quality. Currently, the Air Force is meeting all of its recruiting goals, but what is in store in the future? Recruiters are competing with a robust economy. Jobs in the U.S. are abundant. Is the retirement system responsible for the decline in interest in the military? Predictably, retirement is near the bottom of the list of reasons why new recruits entered the Air Force.[11] Current pay is more attractive than retirement pay in the compensation equation for new recruits. However, I think the retirement system still has an affect on recruitment. What can not be measured is the number of potential high quality recruits who do not step into the recruiting office because the Air Force offers a less attractive compensation package than a civilian employer does. An even more sobering affect is the declining number of veterans. Many possible recruits will look for advice from someone that has served in the military. If that future recruit can find one, what will he or she say? If its an 8 year veteran that recently left the service, he or she might tell the possible recruit all the reasons to get out instead of the reasons to enlist. A change in the retirement system would beef up the compensation package and give the recruiting offices one more tool to attract quality people. In addition to retention and recruitment affects on readiness, a decrease in morale can be just as damaging.

As many of the post 1986 airmen learn the details of their REDUX retirement plan, they feel betrayed. According to Air Force Times, a third term enlisted member had been expecting 50 % at retirement and only recently learned of the affect of REDUX on his anticipated retirement check. He said, "I was a little surprised. I can't recall anyone telling me about that."[12] It is only natural to feel cheated when someone in the same career field, doing the same job, will receive a significant amount more at retirement only because he entered the service before 1986. Some argue the military retirement is excessive compared to civilian retirement. However, comparing a civilian career field to the military career is like comparing apples and oranges. There is no civilian career that includes hazardous duty, frequent moves, overseas service, extended family separations, forfeiture of personal freedoms, sacrifices by family members, and forced midlife career change made difficult by specialization skills that (in some cases) have limited utility in civilian life.[13] Classifying the retirement pay for this 20-year commitment as excessive is insulting to veterans. Eroding the military retirement system negatively affects morale. As former Chairman of the Joint Chiefs of Staff, General Colin Powell said while defending the military retirement against further cuts during his tenure:

> The current military retirement system was designed to produce a young, combat ready military force. In achieving this goal, however, we require our military to retire at younger ages…A nearly simultaneous proposal to dramatically reduce retirement entitlements for these same members, as well as veterans of previous conflicts will vitiate our efforts to care for our members' well-being and can easily generate significant morale problems…[14]

An improvement in the retirement system would send a strong signal that our leadership cares about the financial well being of the members of the armed forces. It would improve morale and therefore improve overall military readiness.

Notes

[1] Peter Grier, "The Retention Problem Spreads," Air Force Magazine, October 1998, 60.

[2] Ibid.

[3] Master Sergeant Patterson, HQ USAF/DPFFR, Office of Retention Policy, interviewed by author, 8 March 1999.

[4] Ibid.

[5] Grier, 61.

[6] Ibid.

[7] Ibid, 62.

[8] Major Jennifer Hesterman, Commander 48 MSS, RAF Lakenheath, Jan 96 – Jun 98, interviewed by author, 12 March 1999.

[9] "The Labor Market for the Soldier," The Office of Economic and Manpower Analysis (West Point, NY: Department of Social Sciences, 1998)

[10] Terry Stevens, "Forrest Gump Must Not be Called Back" Air Force Times, 6 April, 1998.

[11] Lt Col Brett Stevens, Chief of Retirements Branch, AFPC, interviewed by author, October 1998.

[12] Jack Weible, "No Thanks!," Air Force Times, 27 April 1998.

[13] Department of Army, Compensation and Entitlements Branch, "Military Thrift Savings Plan (TSP) Raises Retirement, Readiness Risks Compared to Alternative Savings Options," 1998.

[14] Office of the Secretary of Defense, Force Management Policy, "Assessment of the Costs and Benefits of a Uniformed Services Payroll Savings Plan (USPSP)," 8 April 1998.

Chapter 4

Proposed Changes to the Military Retirement

Today, all signs are that the change has backfired badly.

—Bruce D. Callander, Air Force Magazine, January 1998
referring to the 1986 Military Retirement Reform Act

Many people, organizations and think tanks have developed proposed changes to the military retirement system. Some propose elimination of the 20-year retirement while others simply propose going back to the old system. The office of the Secretary of Defense tasked the RAND Corporation to research a possible change to the military retirement system. RAND used a computer simulation to empirically model the retirement system. They considered the dual purpose of the retirement system as a personnel management tool and a compensation tool. RAND paid close attention in their study to the affects of whether the system induces the most able personnel to stay and seek advancement and whether the system encourages personnel to work hard and effectively.[1] They developed a mathematical model to simulate 3 parameters: retention decisions, individual effort decisions and the relationship between ability and compensation. They conducted a study in 1994 and again in 1998, and they noticed some interesting affects. While the all or nothing 20-year retirement is important for retaining experience, it can also facilitate retention of too many people between the 10 and 20 year point. There has to be a mechanism for voluntary separation of military members between the 10 and 20 year point. Additionally, both retirement and inter rank pay are important motivators for promotion and effort. Lastly, their model factored in the costs of each proposed change. The first alternative RAND analyzed was the current REDUX system with "band aid vesting." This program provided an old age annuity (60 years old) to service members with less than 20 years of service. The biggest draw back of this proposal was the expense coupled with no appreciable affect on force management or effort level.[2] Next, they analyzed a 15-year retirement option. This option proved effective as a short term force management tool during the drawdown, however RAND did not recommend it as a long term solution. It raises the cost of the current REDUX by 10% while creating a post 15-year retention problem within the officer corps.[3] One of the more radical options RAND studied was an abolishment of the 20-year system and replacement of it with an old age annuity, plus a skewed pay raise (steeper raises for the senior ranks). In addition, service members when leaving the military, would receive a lump sum separation payment. RAND determined this system would be the same cost as REDUX while providing a flexible force management tool. The skewed active duty pay chart would give greater reward for promotion instead of longevity, hence increased effort.[4] In their 1998 study, RAND looked at variations of a Military Federal Retirement System (MFERS). In this report, they emphasized some type of tax advantaged retirement savings plan to get away from the all or nothing prospect facing the 10 to 19 year service members. MFERS has 2 parts: a basic benefit plan and a thrift savings plan. The basic benefit plan is an old age annuity equal to 1% of highest 3-year average pay, times years of service. The thrift savings plan would provide a tax deferred savings plan with government contributions equaling 1% of basic pay. Additionally, the government would match up to 5% of the beneficiary's contributions.[5] This plan could be invested in a variety of government securities or a stock fund. Upon leaving the military, the member could roll this plan over into an Individual Retirement Account (IRA), take a lump sum distribution (with a 10% penalty if under 55) or finally, purchase a lifetime annuity.[6] According to the RAND model, MFERS without an accompanied pay raise, reduced retention because for those staying beyond 20 years of service, it significantly reduced the value of their retirement compared to REDUX. For those serving less than 20 years, it did provide earlier vesting. Overall, MFERS without a pay raise was less generous to the military member and created a retention problem.[7] Another possibility RAND analyzed was a MFERS program with a skewed pay raise. This proved to be less costly than REDUX and it increased productivity, however it forces involuntary separation for those over 20 years of service. Since there was no incentive under this plan for voluntary separation after 20 years of service, RAND proposed a MFERS program with a skewed pay raise and with separation pay. This was equal in cost to REDUX while increasing productivity and reducing involuntary separation.[8] There are similar variations of the MFERS plan discussed among the service leaders.

Two of the more common plans are the Thrift Savings Plan (TSP) and the Uniformed Services Payroll Savings Plan (USPSP). The Thrift Savings Plan is similar to the one discussed under MFERS, except advocates of this particular plan, propose a non-matching, optional plan. Under this plan, members would be allowed to save up to 5% of their basic pay in a military version of the TSP.[9] This plan had three main initiatives. First, it would allow REDUX military members to offset their reduced retirement with personal tax deferred savings. Second, it would allow service members to utilize the stock market as a vehicle for tax advantaged savings for retirement. Lastly, it would provide some benefit to members that do not serve for a 20-year career. This personal tax-deferred TSP could be rolled into an IRA after the member separates from the service.[10] A very similar plan, USPSP, is essentially a TSP specifically for the military. The cost of the administration of this program would be minimal if it was rolled into the TSP program. In this program, costs are essentially passed on to the participants in the form of administration fees. The million plus military work force constitutes the largest single work force in the United States without an employed sponsored tax advantaged payroll savings plan.[11] There is a precedent for federal employees moving to this type of plan. There have been 10 government agencies over the past 10 years that have implemented similar plans with no reduction in their existing retirement system benefits.[12] Unfortunately, most military lobbyists do not support this proposal. They have some valid concerns that support their opposition. Despite concerns by military leaders about the retirement system, most legislators are more prone to cutback than beef up the military retirement system.[13] Organizations like The Retired Officers' Association (TROA) fear that opening up the retirement system to legislative action by Congress may lead to further reductions in the current retirement system. A program like TSP would only be approved with further cuts to the military retirement system.[14] In fact, as part of the Gramm-Rudman-Hollings ACT of 1985, the reduced tax revenue produced by this tax-advantaged plan would have to be offset by cuts from other areas of the military compensation budget. This process is referred to as "Pay as You Go" or PAYGO and was instituted as an initiative to balance the budget.[15] Most service leaders feel that any tax-advantaged program, coupled with further military retirement cuts, will spark additional retention problems. Military members would feel they were making up the difference with their own savings plan. The only way either of these two plans would work is if they were not accompanied by further reductions in retirement benefits. Some feel all these considerations are too complicated and we need a simple improvement to the retirement system.

The Pentagon supports a plan to replace the REDUX retirement plan with the old High 3 Plan. The proposal has initial White House backing, and on Feb. 24th 1999, it cleared the Senate. Under the new plan, REDUX service members chose at the 15 year point whether to remain under REDUX and receive a $30,000 cash bonus, or revert to the High 3 retirement plan. The proposal also includes a military Thrift Savings Plan. Participants could invest up to 5% of basic pay along with any bonuses they receive. The services would be authorized to match up to 5% of basic pay in exchange for extending their active duty military commitments. Finally, the plan includes a 4.8% across the board pay raise effective January 2000. Additionally, it includes a targeted raise of up to 5.5% depending on rank and years of service.[16] However, this proposal has not been passed in the House of Representatives and is still a long way from becoming law. The Chiefs of Staff have gone on record as making this proposal their number one priority. They are hoping to persuade Congress to enact the plan into law.[17] But will they be successful? According to Congressman (R-Ind.) Steve Buyer's aide, "There must be concrete evidence the retirement plan is causing service members to leave in droves – even to the point of affecting national security-before Congress will even consider a return to the 50% system. Even the cost of switching back probably would be politically unfeasible in an era of tight Department budgets."[18] If Congress approved the change back to the High 3 plan, what is to stop the Congress from attacking the retirement system later on down the road when readiness is not an issue, and they are looking for budget cuts? The new system must be one that provides tax advantaged savings, but does not significantly increase budget requirements and is shielded from future budget cuts.

Notes

[1] Beth T. Asch, John T. Warner, *A Policy Analysis of Alternative Military Retirement Systems,* RAND Report (Santa Monica, CA, 1994), 3.

[2] Ibid., 52.

[3] Ibid., 57.

[4] Ibid., 59.

[5] Beth T. Asch, Richard Johnson, John T. Warner, *Reforming the Military Retirement System*, RAND Report (Santa Monica, CA, 1998), 8.

[6] Ibid.

[7] Ibid., 41.

[8] Ibid., 77.

[9] Department of Army, Compensation and Entitlements Branch, "Military Thrift Savings Plan (TSP) Raises Retirement, Readiness, Risks Compared to Alternative Savings Options," 1998.

[10] Department of Army, Compensation and Entitlements Branch, "Assessment of the Costs and Benefits of an Uniformed Services Payroll Savings Plan (USPSP)", 1998, 2.

[11] Ibid.

[12] Ibid, 10

[13] Department of the Army, "Military Thrift Savings Plan (TSP) Raises Retirement, Readiness Risks Compared to Alternative Savings Options"(paper, Washington, D.C.), 1998.

[14] Colonel (Ret USAF) Paul W. Acari, Director Government Relations (TROA), letter, subject: TROA position on TSP, 14 January 1997.

[15] "Assessment of the Costs and Benefits of a Uniformed Services Payroll Savings Plan (USPSP)", 15.

[16] Tom Philpott, "Senators Overload Military Benefits Bill; Collapse Possible," *Montgomery Advertiser*, 28 February, 1999.

[17] Rick Maze, "4.4% and More Clears the White House," *Air Force Times*, 21 Decemeber, 1998.

[18] Weible, 11.

Chapter 5

Recommendation

The best military retirement system should provide tax-advantaged savings in addition to the basic 20-year retirement plan without significantly increasing the cost to the taxpayer. It is based on four principles. First, keep the basic 20-year retirement plan in tact as it exists under REDUX. Second, implement the Uniformed Services Payroll Savings Plan (USPSP) as the vehicle for tax advantage savings. Third, increase basic pay for all military members. The final step of the plan is to privatize the military retirement account.

The basic 20-year retirement annuity is still a good plan and cherished by military members. It is still a solid force management tool used as an inducement to serve a 20-year career in the military. It is not excessive, as some have argued, but a deserved reward following a career of sacrifice and service unmatched in the civilian sector. It should still be the cornerstone of the military retirement system. The one necessary adjustment needed for REDUX is a change to the cost of living adjustment to match the formula used in the High 3 plan. However, this change alone is not enough to solve the retention and recruitment issue. A tax-advantaged plan is needed.

By adopting the USPSP, service members will have additional retirement funds or a lump sum payment to use in transition to a second career. There are two options for this plan. The first is a matching plan. Under this option, the member is permitted to save up to 10% of his basic pay in the tax-deferred account. The government will match the first 5% of the contributions. This plan has many advantages. First of all, it provides an incentive for members to invest in their own retirement by providing an immediate 50% gain on the first 5% of the contributions. Additionally, military leaders can use the matching funds as a force management tool. By tying the matching funds to a vesting period, the government can provide incentive for certain specialties to remain on active duty. Conversely, shorter vesting periods for over manned career fields provide incentive for voluntary separations. The biggest short fall to the matching plan is that it is expensive. Additionally, it may provide a mechanism for Congress to use it in place of the 20-year annuity instead of as a supplement. Ideally, this is the best plan if it is used as a supplement. However, Congress would likely look to cut the basic retirement in order to pay for the matching USPSP. For this reason, a voluntary, non-matching USPSP should be instituted. It still provides something for the service members who separate prior to 20 years, without giving Congress the ammunition to attack the basic plan.

The next step in the plan is an immediate basic pay increase of 10%. This is on top of any inflation or cost of living increase. Most estimates put the military pay gap at around 13.5%.[1] The pay gap is a comparison of military salaries in relation to similar careers in the civilian world. A pay raise is more valuable to the service member than going back to the High 3 retirement plan. First of all, service members value current pay more than retirement pay and an increase would have a direct, positive impact on retention, recruitment and morale. Next, the pay increase would give service members more disposable income to invest in their USPSP. One common criticism of the USPSP plan is that a low percentage of service members would participate because they traditionally have a lower average savings rate than the civilian sector.[2] If base pay is increased to eliminate the pay gap, then the military member can save more toward his or her own retirement in a tax advantaged program like USPSP. A third reason is that a higher base pay means higher retirement pay. A comparison of the proposed plan and the High 3 plan is shown in Table 3. The approximate base salary of an E-7 with 20 years of service is used for the comparison. In the example, an airman enters service at age 18 and saves $100 a month in his USPSP. Contributions are increased to keep up with inflation. His USPSP account grows at an average annual rate of 10.5% (historic average return of the S&P 500 index).[3]

Table 4. Plan Comparison

	PROPOSED PLAN	***HIGH 3 PLAN***
Base salary at retirement	**$33,000**	**$30,000**
Retirement annuity	**$13,200**	**$15,000**
USPSP annuity	**$2,850***	**0**
Total retirement salary	**$16,050**	**$15,000**

Source: Calculations accomplished using Quicken Financial Calculator
All figures are in today's dollars assuming a 4% inflation rate
*Total USPSP annuity value after 20 years is $95,540. Assumes member immediately withdraws annual contributions from age 38 to 76.

Clearly, the proposed plan comes out ahead of the High 3 plan. The last advantage of the proposed plan over a return to the High 3 plan is the likelihood of it withstanding future congressional budget attacks. If the High 3 is reinstated, what is going to stop Congress from going after military retirement in the future, when unemployment is high and retention, recruitment are not affecting readiness? Congress is far more likely to cut High

3 again than to implement basic pay cuts. The question now is how does a fiscally responsible Congress pay for a 10% pay increase?

Congress needs to change the investment strategy for the military retirement account. In 1985, as part of the military reform act, Congress began budgeting for future military retirements.[4] Each year, Congress invests between $10-$12 billion for future military retirees. The actual number is calculated using a percentage of basic pay for that year.[5] Where does that money go during a service member's 20-year career? It is disappointing to know that 100% of it is invested in government securities. The historic return on long term government securities is 5.2%.[6] A percentage of the military retirement account should be invested in common stocks. The historic return of the S&P 500 is double that of long term government securities. If the military retirement account earns more money, the taxpayer can contribute less of his annual tax dollars. Some would argue that the stock market is too risky. The risk associated with the stock market is a disadvantage to this plan. However, over a 20-year investment period, the market has historically outpaced government securities. In addition, under the proposal, only a percentage of the military retirement account would be invested in the stock market. This would help dilute the effect in a down year in the market. The savings in annual contributions can be used to pay for the basic pay increase.

Notes

[1] Callander, 40.

[2] "Military Thrift Savings Plan (TSP) Raises Retirement, Readiness, Risks Compared to Alternative Savings Options,"

[3] Herbert B, Mayo, *Investments, An Introduction 5th Edition* (Fort Worth : The Dryden Press, 1997) 282.

[4] Senate, Committee on Armed Services, Subcommittee on Manpower and Personal, *Proposal to Change Military Retirement*, 99th Cong., 1st sess.,1985 (Wahington, D.C.:Government Printing Office, 1986) 106.

Notes

[5] Lt Col Jack Faires, Lt Col Joseph Whitley, Lt Col Bruce Wilson, *Military Retirement-- Is It Time to Change?* (Carlisle, PA, U.S. Army War College, 1998), 24.

[6] Mayo, 282.

Conclusion

The bottom line of any change in the retirement system is fiscal responsibility. The current plan proposed by the White House and passed by the Senate is appealing to the author. However, these proposals are not yet approved by the House, and more importantly they are not funded. There is a concern that Congress will not finance these improvements and the military will have to fund them from another source in the budget. This could ultimately lead to decreases in other quality of life initiatives or readiness issues. While returning to the High 3 system with a TSP is a great solution, the author believes it would not be permanent, and Congress would attack the retirement system again in the future. The money would be better spent to increase pay and initiate the USPSP. Finally, changing the investment strategy for the military retirement account can finance the cost of these changes. This will have a more lasting effect on readiness and would be more resilient from attacks by Congress. The time is now to make it better!

Glossary

CMSAF	Chief Master Sergeant of the Air Force
COLA	Cost of Living Allowance
CPI	Consumer Price Index
IRA	Individual Retirement Account
MFERS	Military Federal Retirement System
MRRA	Military Retirement Reform Act of 1986
MSS	Mission Support Squadron
Pay GO	Pay as you go
RAF	Royal Air Force
REDUX	Another name for Military Retirement Reform Act of 1986
TROA	The Retired Officers' Association
TSP	Thrift Savings Plan
UCMJ	Uniformed Code of Military Conduct
USAF	United States Air Force
USPSP	Uniformed Services Payroll Savings Plan

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